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Punitive Treatment of Mortgage Servicing Rights under Basel III Needs to Be Revisited

- **About MidFirst Bank**

MidFirst Bank is a federally chartered savings association with $13 billion in assets and ranks as one of the nation's premier privately held banks. Headquartered in Oklahoma City, MidFirst Bank has more than 50 banking centers in Oklahoma, 24 banking centers in Arizona, and three (3) banking centers in Denver. In addition, MidFirst Bank services home mortgage loans nationwide and is the 12th largest servicer of FHA loans in the country.

- **Description**

Basel III, as implemented in the U.S. by the domestic federal regulators at the Federal Reserve, OCC and FDIC, placed overly restrictive limits on the amount of Mortgage Servicing Rights (MSRs) that could be held by federally regulated financial institutions (banks).

Basel III implementation restricted bank investments in MSRs and transformed MSRs into one of the most costly asset classes for a bank to hold on its balance sheet. Basel III reduced the regulatory cap on MSRs to 10% of the common equity component of tier one capital, representing an 80% decrease from pre-Basel III limits – prior to Basel III, bank MSR investments were limited to 50% of the common equity component of tier one capital. MSR assets in excess of the 10% Basel III limit result in a deduction from regulatory capital. In addition, the aggregate limit for MSRs, deferred tax assets and equity interests in unconsolidated financial entities was established as 15% of the common equity component of tier one capital. Further, the implementation of Basel III significantly increased the risk-weighting of MSRs from 100% to 250%.

The restrictive treatment imposed by Basel III has had a disparate impact on U.S. banks due to the uniquely American system that uses private and public sector mortgage insurance to provide liquidity to the mortgage market. In response to the punitive treatment of MSRs under Basel III, banks have sold MSRs because of the undue expense in holding them. The treatment is unwarranted given that there is a liquid market for MSRs and that MSRs have contractual cash flows with risks that can be effectively managed.

The rationale for the risk-weighting in 2012 was based upon faulty logic that no longer applies in the 2017 environment. When proposed by the Basel Committee in 2012, the treatment of MSRs was viewed in light of the economic crisis that was (in part) set off by abuses in the U.S. mortgage lending market. MSRs were viewed as particularly risky in 2012 as a result of poor mortgage performance during the crisis (2008-2012) when subprime and Alt-A mortgage defaults spiked total mortgage default rates to historical highs. However, the mortgage crisis was linked to origination practices and home prices – not MSRs. Banks know how to hedge and manage MSRs, as evidenced by the fact that there were no bank failures resulting from MSRs. In addition, since 2012 a host of mortgage market reforms have been enacted to enhance stability in the mortgage market.

It is time to make sure that the regulatory framework appropriately addresses the nature and importance of MSRs as a vehicle for consumer mortgage finance.

- **Impact on Consumers and Market Participants/Economic Impact**

The impact of the punitive Basel III treatment of MSRs has been felt by banks and consumers.

Smaller insured financial institutions: Basel III treatment of MSRs has a particularly negative impact on smaller insured financial institutions. The punitive regulatory framework for MSRs discourages lending by small institutions. Because MSRs are expensive to hold, smaller banks are forced to limit their mortgage lending, which limits consumer access to mortgage financing.

Consumers: Consumers bear the ultimate cost of the Basel III restrictions on MSRs, as the increased cost of capital translates to reduced willingness to lend and/or higher consumer borrowing cost on loans.

- **Specific Recommendations**

The Senate Banking Committee should require the federal bank regulators to remove the punitive restrictions placed on MSRs by changing the risk-weighting back to 100% to match the pre-crisis treatment, eliminating the 10% MSR cap, and excluding MSRs from the 15% aggregate cap. Furthermore, the federal banking regulators should seriously study how to include the value of mortgage insurance into the risk-weighting of MSRs and how voluntary reserves can be afforded consideration to offset any capital deduction requirements.

- **Legislative Language**

A BILL

To require the appropriate Federal banking agencies to adjust the treatment of mortgage servicing assets with respect to non-systemic banking institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Community Bank Mortgage Servicing Asset Capital Requirements Act of 2017".

SECTION 2.

IN GENERAL.— Section 171 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5371) is amended by adding at the end the following:

"(8) TREATMENT OF MORTGAGE SERVING ASSETS UNDER BASEL III CAPITAL REQUIREMENTS

(a) DEFINITIONS

For purposes of this Act:

(1) BANKING INSTITUTION.—The term "banking institution" means a bank holding company, insured depository institution, or savings and loan holding company.

(2) BASEL III CAPITAL REQUIREMENTS.—The term "Basel III capital requirements" means the final rules titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule" (78 Fed. Reg. 62018; published Oct. 11, 2013 and 79 Fed. Reg. 20754; published April 14, 2014).

(3) FEDERAL BANKING AGENCIES.—The term “Federal banking agencies” means the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

(4) MORTGAGE SERVICING ASSET.—The term “mortgage servicing asset” means the contractual rights owned by a banking institution to service, for a fee, mortgage loans that are owned by others.

(5) NON-SYSTEMIC BANKING INSTITUTION.—The term “non-systemic banking institution” means any banking institution other than an institution identified by the Financial Stability Board as a “global systemically important bank”.

(6) OTHER DEFINITIONS.—The terms “bank holding company”, “insured depository institution”, and “savings and loan holding company” have the meanings given such terms, respectively, under section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(b) TREATMENT OF MORTGAGE SERVING ASSETS UNDER BASEL III CAPITAL REQUIREMENTS

(1) TREATMENT OF MORTGAGE SERVICING ASSETS IN THE CALCULATION OF CAPITAL OF UNCONSOLIDATED FINANCIAL INSTITUTIONS.—For purposes of the Basel III capital requirements application to non-systemic banking institutions and any other regulation which seeks to establish regulatory capital rules relating to the treatment of mortgage servicing assets for non-systemic banking institutions, the appropriate Federal banking agencies shall treat mortgage servicing assets as:

(A) Limited to 100 percent of common equity tier 1 capital, net of goodwill, other intangibles and other disallowed assets;

(B) Excluded from the items subject to the 10 percent and 15 percent common equity tier 1 capital deduction thresholds; and

(C) Included in the risk-weighted assets of the non-systemic banking institution and assigned a 100 percent risk weight.

(2) AMENDMENT TO BASEL III CAPITAL REGULATIONS.—Not later than the end of the 3-month period beginning on the date of the enactment of this Act, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency shall amend the Basel III capital requirements to implement the amendments made by this Act.

(c) STUDY OF THE APPROPRIATE RECOGNITION OF MORTGAGE INSURANCE AND RESERVES

(1) IN GENERAL.—The Federal banking agencies shall, jointly, conduct a study of the regulatory approaches available to:

(A) Recognize the value of mortgage insurance when setting capital standards and specifically, setting risk weights for mortgage servicing assets for non-systemic banking institutions; and

(B) Recognize the value of any voluntary reserves a non-systemic banking institution elects to hold against mortgage servicing assets as an offset to any capital deduction requirements.

(2) REPORT TO CONGRESS.—Not later than the end of the 1-year period beginning on the date of the enactment of this Act, the Federal banking agencies shall issue a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives containing the results of the study required under subsection (1).